ITALIAN REPUBLIC

Rating Analysis - 1/11/11
Debt: EUR1,763.6B, Cash: EUR80.0B

EJR Sen Rating(Curr/Prj) BBB-/ BB+
EJR CP Rating: A2
EJR's 1 yr. Default Probability: 2.7%

Italy's economy grew by a slower than expected 0.2% QoQ (1.1% YoY) in Q3 2010, down from 0.5% in Q2 2010. Economists had expected growth of 0.4% in the quarter. Meanwhile, unemployment reached 7.6% in Q3 2010, up 0.3% from the year prior with 1.8 million persons unemployed. In November 2010, consumer prices as measured by the CPI held steady over the month prior and increased 1.7% YoY. The EU HICP recorded a 1.9% increase YoY. During the same month, the industrial producer price index rose by 4.0% YoY (+4.1% on the domestic market and +3.5% on the non-domestic market).

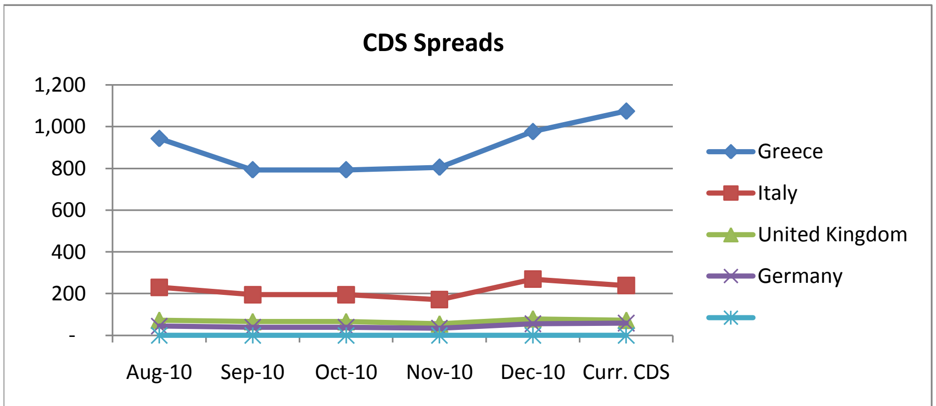
On Tuesday, January 11, 2011, the Italian Treasury sold a planned €7B in 12-month T-bills with an average yield of 2.067%, up from 2.014% on the previous December 2010 offer. The auction was over-subscribed with the Italian Treasury receiving €11B in bids and an overall bid-to-cover ratio of 1.63.

Spreads between Italian 10-year bonds and comparable benchmark German bunds have hit record highs. Italy's CDS spreads are 241.5 and have been fairly stable.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	Jan-00	Jan-00	Dec-00	Dec-01	Jan-03	Jan-04
Debt/ GDP (%)	94.1	108.3	116.4	125.1	130.6	136.3
Govt. Sur/Def to GDP (%)	-2.7	-5.3	-1.6	-1.2	-1.1	-1.1
Adjusted Debt/GDP (%)	100.0	114.6	122.9	131.8	137.1	142.8
Interest Expense/ Taxes %	17.7	15.9	15.2	16.5	17.3	18.1
GDP Growth (%)	-2.8	1.1	-2.0	-2.0	1.0	1.0
Foreign Reserves/Debt (%)	1.5	1.4	1.3	1.2	1.1	1.0
Implied Sen. Rating	BB	BB	BB	B+	B+	B+

INDICATIVE CREDIT RATIOS	AA	A	BBB	BB	B	CCC
Debt/ GDP (%)	40.0	50.0	60.0	80.0	120.0	150.0
Govt. Sur/Def to GDP (%)	5.0	3.0	0.5	-2.0	-5.0	-9.0
Adjusted Debt/GDP (%)	45.0	55.0	65.0	85.0	125.0	155.0
Interest Expense/ Taxes %	7.0	9.0	12.0	15.0	22.0	26.0
GDP Growth (%)	5.0	4.0	2.0	1.0	-1.0	-5.0
Foreign Reserves/Debt (%)	25.0	20.0	15.0	12.0	9.0	7.0

PEER RATIOS	S&P Sen.	Debt as a % GDP	Govt. Surp. Def to GDP (%)	Adjusted Debt/ GDP	Interest Expense/ Taxes %	GDP Growth (%)	Ratio-Implied Rating*
United Kingdom	AAA	76.7	-11.4	95.8	6.9	-4.9	B+
Federal Republic Of Germany	AAA	68.6	-3.0	75.1	10.7	3.9	BB+
Kingdom Of Spain	AA	49.8	-11.1	55.4	9.6	0.2	BBB-
Italian Republic	A+	108.3	-5.3	114.6	15.9	1.1	B+
Hellenic Republic (Greece)	BB+	117.2	-15.4	120.5	25.8	-4.6	CCC+



Country (EJR Rtg*)	Current CDS	Targeted CDS
Greece(B+)	1,074	600
Italy(BBB+)	238	158
United Kingdom(AA)	72	30
Germany(AA)	58	30
()		

* Projected Rating

Main Economic Indicators

Italy has one of the most developed economies in the world, resulting in high standards of living. Its per capita GDP of US$35,360.86 is higher than the EU average. The Italian economy is exceedingly diversified with a highly developed industrial north and a less developed, welfare-dependent agricultural south. Overall, the economy is driven in large part by the manufacturing of high-quality consumer goods.

The country fell into recession during Q2 2008 with -0.7% GDP growth after nearly 12 consecutive quarters of positive economic growth. The economy did not begin to recover until Q3 2009. Now, nine quarters after having initially slipped into recession, Italy has begun to show slight signs of economic recovery due in large part to floating trends on exports and the resilience of household consumption. The economy expanded 0.4% seasonally adjusted QoQ during the first quarter of 2010. By Q2 2010, GDP rose 0.5%, only half the pace of growth throughout the eurozone in the same period due mainly to a 3.3% increase in exports. In the third quarter, GDP growth slowed somewhat to a lesser than expected 0.2% growth. In the most recent Q3 2010, the economy slowed more than expected as GDP recorded growth of 0.2% over Q2 2010 and 1.1% YoY.

Italy is currently among the world's most heavily indebted countries, which is only enhanced by its slow growth. This year, public debt as a percentage of GDP is expected to rise 3% to 118%. Italy's outstanding public debt is €1.7 trillion euros, seven times the size of Greece. The country's outstanding debt is exceedingly difficult to reduce, and failure to do so will weigh on the economy over the long term. Despite these levels, markets have deemed Italy less risky than other Southern European nations. Italy levies a relatively high tax and social security burden on labor income. On average, single taxpayers take home less than 55% of total labor costs.

Despite massive outstanding debt, Italy is relatively healthy in terms of its annual budget. Its deficit, equivalent to 5.3% of GDP in 2009, is below the EU average of 6.3%. Italy successfully narrowed its deficit in the third quarter of 2010, leaving the economy on track to meet the government austerity target of 5% of GDP in 2010. Italy is targeting a public deficit of 3.9% in 2011 and 2.7% in 2012. The country has made significant progress in reducing regulatory costs. Such progress, if continued, will speed up its recovery and make its economy more competitive in the process.

Further Indicators: Inflation and Unemployment

In November 2010, Italy's National CPI remained unchanged from October 2010 and rose 1.7% in comparison to the same month of the previous year. Meanwhile, the EU's Harmonized Index of Consumer Prices (HICP) rose by 1.9% in comparison to the same month of the previous year.

Unemployment has also increased in recent months. In the third quarter of 2010, the total number of unemployed persons in Italy increased by 50,000 to 1.8 million people, raising the unemployment rate 0.3% YoY to 7.6%. During the same quarter, the *employment* rate decreased to 56.7% from 57.5% in the third quarter of 2009. Italy's statistics office estimates that a total of 22.8 million persons were employed in the third quarter of 2010.

Export Dependent Economy

Italy is the world's seventh-largest exporter. Overall, more than 60% of its trade is conducted with fellow EU partners. Throughout the first half of 2010, trade increased by 12.6% for exports (12.2% for EU countries and 13.2% for non EU countries) and by 18.5% for imports (16.2% for EU countries and 21.6% for non EU countries) as compared with the first quarter of 2009. Overall, the trade balance presented a deficit of 14.2 billion euro during the first half of 2010. Foreign trade with non-EU countries presented a surplus (excluding energy) of 14,266 million euros.

In October 2010, total exports increased by 17.6% over the year prior with a 21.9% increase for non-EU countries and a 14.5% increase for the EU area. Imports increased by 22.5% YoY during the month, up 32% for no EU countries and up 16% within the EU area. Year to date, Italy is recording a trade deficit of €21.2B.

Regulatory Environment
The Italian government has made significant progress in cutting regulatory costs, a step which is key to enhancing productivity and, in effect, economic growth. Such reform will also aid in making Italy's economy more competitive on a global scale.

The World Bank Group - Doing Business 2010 Survey: Italy

Ease of…*	2011 Rank	2010 Rank	Change in Rank
Doing Business	**80**	**76**	**0**
Starting a Business	68	74	**-5**
Dealing with Construction Permits	92	85	**0**
Registering Property	95	97	**-1**
Getting Credit	89	87	**0**
Protecting Investors	59	57	**0**
Paying Taxes	128	128	**0**
Trading Across Borders	59	54	**0**
Enforcing Contracts	157	157	**0**
Closing a Business	30	29	**0**

* Measures 183 countries, based on a scale of 1 to 183 with 1 being the highest ranking.

Source: DoingBusiness - The World Bank Group

Nationwide Problems
The country continues to face a number of persistent problems including illegal immigration, organized crime, corruption, high unemployment, slow economic growth and low income in the southern regions (in comparison to the prosperous North). Italy also has widespread tax evasion and a significant underground economy which accounts for roughly 27% of GDP (2008).

The Italian government has been very active in implementing new structural reforms. They have been successful in overhauling costy entitlement programs and in effect increasing opportunities for employment. Reports show that the 2009 tax amnesty program implemented to repatriate untaxed assets held abroad has netted the federal government more than $135 billion.

Planned Austerity Measures
To date, Italy's recovery efforts have remained less successful than that of its European peers. Italy recently passed a €25 billion austerity package aimed at reducing the country's budget deficit. Over the next two years, the government will aim to bring its public deficit down to 2.7% of GDP. The deficit currently stands at 5.3% of GDP, surpassing the EU limit of 3%.

The new budget consists of cuts in transfers to local governments as well as a crackdown on tax evasion. Furthermore, the measures call for a three-year salary freeze on public workers, a three to six month delay in salary retirement dates, and a 10% cut in ministry budgets. Prime Minister Silvio Berlusconi has argued that had the austerity measure not passed, international speculation would have driven the country into an increasingly dangerous economic position. The OECD has forecast that Italy's economy will be the only one among the G7 nations to contract in Q3 2010.

Assumptions for Projections

	Peer	Issuer	Base Case	
Income Statement	**Median**	**Average**	**Yr 1&2**	**Yr 3,4,5**
Taxes Growth%	(4.8)	(3.2)	**(3.0)**	**0.5**
Social Contributions Growth %	(1.8)	(0.4)	**0.5**	**0.5**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	0.1	1.2	**1.0**	**1.0**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	(6.4)	(2.0)	**(2)**	**1.0**
Compensation of Employees Growth%	5.2	1.0	**1.0**	**1.0**
Use of Goods & Services Growth%	5.4	7.5	**7.0**	**7.0**
Social Benefits Growth%	8.7	4.9	**4.9**	**4.9**
Subsidies Growth%	2.3	0.3		
Other Expenses Growth%	11.3	11.3	**3.0**	**3.0**
Special Items (millions EUR)	0.0	0.0		
Balance Sheet				
Currency and Deposits Growth%	0.4	18.2	**2.0**	**2.0**
Securities other than Shares LT Growth%	7.8	13.0	**2.0**	**2.0**
Loans Growth%	2.4	2.4	**2.4**	**2.4**
Shares and Other Equity Growth%	14.8	1.1	**1.1**	**1.1**
Insurance Technical Reserves Growth%	2.7	2.7	**2.7**	**2.7**
Financial Derivatives Growth%	0.0	0.0		
Other Accounts Receivable LT Growth%	8.0	2.9	**2.0**	**3.0**
Monetary Gold and SDR's Growth %	0.0	0.0	**5.0**	**5.0**
Other Accounts Payable Growth%	9.2	NMF		
Currency & Deposits Growth%	4.5	4.5	**4.5**	**4.5**
Securities Other than Shares Growth%	16.3	8.8	**6.1**	**6.1**
Growth%	0.0	0.0		
Loans Growth%	0.8	1.7	**1.7**	**1.7**
Insurance Technical Reserves Growth%	0.0	0.0		
Financial Derivatives Growth%	0.0	0.0		
Addl debt. (1st Year) million EUR	0.0	0.0		

Base Case

ANNUAL REVENUE AND EXPENSE STATEMENT (MILLIONS EUR)

	Jan-00	Jan-00	Jan-00	PDec-00	PDec-01	PJan-03
Taxes	460,574	456,237	441,857	428,601	415,743	417,822
Social Contributions	205,259	215,911	215,003	216,078	217,158	218,244
Grant Revenue	0	0	0	0	0	0
Other Revenue	51,190	51,641	52,274	52,797	53,325	53,858
Other Operating Income	0	0	0	0	0	0
Total Revenue	717,023	723,789	709,134	697,476	686,226	689,924
Compensation of Employees	163,989	169,813	171,578	173,361	175,163	176,984
Use of Goods & Services	81,016	86,241	92,718	99,208	106,153	113,584
Social Benefits	306,247	320,031	335,816	352,380	369,760	387,998
Subsidies	14,872	15,053	15,103	15,105	15,106	15,108
Other Expenses	61,166	59,511	66,239	11,025	66,239	68,226
Grant Expense	0	0	0	0	0	0
Depreciation	27,700	28,965	29,706	29,706	29,706	29,706
Total Expenses	654,990	679,614	711,160	680,784	762,127	791,605
Operating Surplus/Shortfall	62,033	44,175	-2,026	16,692	-75,901	-101,681
Interest Expense	76,884	80,685	70,304	65,013	68,470	72,138
Net Operating Balance	-14,851	-36,510	-72,330	-48,321	-144,370	-173,819

ANNUAL BALANCE SHEETS (MILLIONS EUR)

ASSETS	Jan-00	Jan-00	Jan-00	PDec-00	PDec-01	PJan-03
Currency and Deposits	58,323	67,726	80,032	81,633	83,265	84,931
Securities other than Shares LT	13,674	15,375	17,367	17,714	18,069	18,430
Loans	51,199	53,942	55,226	56,541	57,886	59,264
Shares and Other Equity	145,222	129,184	130,663	132,159	133,672	135,202
Insurance Technical Reserves	1,596	1,502	1,543	1,585	1,628	1,673
Financial Derivatives						
Other Accounts Receivable LT	126,789	129,830	133,574	136,245	138,970	143,140
Monetary Gold and SDR's						
Additional Assets	0	0	0	0	0	0
Total Financial Assets	396,803	397,559	418,405	425,877	433,491	442,640
LIABILITIES						
Other Accounts Payable	56,891	56,217	57,804	57,804	57,804	57,804
Currency & Deposits	211,987	211,158	220,713	181,808	234,282	311,628
Securities Other than Shares	1,333,030	1,403,490	1,526,620	1,620,373	1,719,883	1,825,504
Loans	141,123	135,369	137,662	137,662	137,662	137,662
Insurance Technical Reserves						
Financial Derivatives						
Other Liabilities	649	646	641	1,592	1,592	1,592
Liabilities	1,743,680	1,806,880	1,943,440	1,999,239	2,151,223	2,334,190
Net Financial Worth	(1,346,870)	(1,409,320)	(1,525,040)	(1,573,361)	(1,717,732)	(1,891,551)
Total Liabilities & Equity	396,810	397,560	418,400	425,877	433,491	442,640

Sovereign Rating Methodology

Egan-Jones takes the perspective of the investor as its primary point of view when developing the ratings it issues for sovereigns. Therefore, in the case of sovereign ratings, we attempt to take a more holistic view of credit quality to include not only analytic comparisons of various sovereign issuers but also the impact on our quantitative and qualitative analyses by current global, sovereign, governmental and market events, including the effects of government investments in speculative, volatile or other high risk investment products. For example, many sovereign issuers have taken on significant exposures of major financial institutions over the past several years. Hence, we calculate the under-funding of financial institutions and include this amount in the total indebtedness of sovereigns. (We use a base assumption that no country can afford to allow its major banks to fail and therefore we believe that there will almost always be an intervention by either a host or allied nation should financial institutions or markets require support at some measurable level.)

Generally we devise modeling calculators and do an analysis that examines the debt load of a country with respect to its GDP and other economic indicators. The analysis is then adjusted to reflect the outlook on a myriad of factors that reflect the firm's overall view of the sovereign debt and the quality of the country's ability to meet and thrive under such load. Some of the qualitative factors that impact our ultimate assessment of credit quality such as the flexibility, stability and overall strength of the economy, ease of tax collection, acceptance of contract law, ease of doing business, and prospects for future growth and health. The non quant issues are generally subjective and a moving target, so each rating of a sovereign may differ because of the non-quantitative nuances being addressed.

Nota Bene

History has proven that defaults on domestic public debt do occur. In fact, seventy out of three hundred twenty defaults since 1800 have been on domestic public debt (1). Egan-Jones does not view a country's ability to print its own currency as a guarantee against default. Additionally, Egan-Jones generally views cases of excessive currency devaluation as a de facto default.

1. "This Time Is Different: Eight Centuries of Financial Folly", Reinhart & Rogoff, p.111, 126